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February 2016

EQUITY VIEWPOINTS

GLOBAL MARKET COMMENTARY

JANUARY 2016 – STOCKS START THE YEAR ON A WEAK NOTE

Uncertainty about China's economy, exchange rate policy, along with a rapid fall in oil prices saw markets fall sharply in the first month of 2106. The continuing drop in oil prices drove down energy stocks and weighed on sentiment as concerns were raised about the global growth outlook. Oil prices fell to their lowest levels since 2003 as production continued to outstrip demand and investors braced for the arrival of Iranian oil into the market following the mid-month lifting of US and European sanctions. US stocks followed other global markets sharply higher however on the last trading day, following a surprise move toward negative interest rates by the Bank of Japan. Hopes that weak US economic data would encourage the Federal Reserve to follow suit, or at least delay any more rate increases, appeared to further boost sentiment. US Economic news was mixed as GDP growth slowed to 0.7% SAAR in Q4 2015, but the January unemployment rate did dip below 5% for the first time since February 2008.

GLOBAL EQUITY VIEWPOINTS – FEBRUARY 2016

UNITED STATES: The US economy continues to grow at a slow, but sustainable rate, but there is now increased focus on the Fed. Their baseline view remains one of moderate growth. We are aligned much closer to Chair Yellen's relatively upbeat outlook than many gloomy market views; some market scenarios even anticipate an imminent US recession. We believe such fears are unsubstantiated, especially in the absence of discernable catalysts in the real economy. One proximate cause for the market sell-off has been he continued decline in oil prices (briefly touching below US$28 a barrel for Brent). Most experts view these recent sharp price declines to be symptomatic of excess supply caused by a plethora of producers unwilling to cut production. By contrast, markets have interpreted price declines as symptomatic of flagging demand—possibly even a precursor that may lead to a US recession.

Notwithstanding the slow GDP growth reported for the last quarter of 2015, we certainly do not believe that a recession is imminent. Yet, even as the economy remains near full employment, there is little doubt that the market turmoil and continued drop in oil prices has led the Committee to become less confident that inflation would reach its 2% target on the same timetable as they had forecast during their December meeting.

Therefore, with the FOMC's penchant to react to financial market conditions and the rapidly decreasing prospect of inflation reaching that 2% target any time soon, leads us to believe that the previously anticipated rate hikes for 2016 are likely to be delayed.

Overall, we now believe valuations have become much more attractive after the recent falls. We would best describe them as 'reasonable' for where we are in the economic cycle, although we would stress that this view is premised on the continued delivery of earnings growth.

Bull markets usually end with recession or due to valuation bubbles - we see no signs of either. A slowdown in growth abroad does have the potential to impact the US economy, but so far this has not materialized, even despite the last few years of sub-par growth in other developed and emerging economies. There are also less fiscal headwinds for the economy to deal with as Washington reigns in spending ahead of the upcoming elections. Meanwhile, consumption – the largest part of the US economy – continues to perform well. Low to negative cost inflation for corporates (aided by the collapse in oil prices) should also help to stimulate future growth and assist companies in their efforts to derive better results. Additionally, with inflation remaining contained, the Fed is likely to take a more measured approach to future rate hikes, so monetary policy should remain accommodative. Given these factors, we remain reasonably constructive, but the outlook going forward is inherently more stock-specific than it has been for some time.

EUROPE: Despite concerns over global growth, we are still encouraged by economic data coming out of Europe. The composite PMI remains well above the level marking expansion, but on a country basis, economic conditions still remain varied.

It is also encouraging that consumers appear to be regaining a measure of confidence in most markets, and credit conditions appear to have improved. Inflation remains significantly below the ECB target, but the recent move by the ECB to extend its asset purchase program has somewhat improved the outlook for prices.

The theme of independence might well be important in 2016 as the UK has recently announced their plans for

a referendum on its membership of the European Union (23 June), while the Catalonia independence story continues to rumble on. Should the UK cut its ties with the European Union, we envisage a detrimental effect on a significant number of UK-listed companies who benefit from the reduced regulation of transacting across the union.

JAPAN: The Bank of Japan (BoJ) joins the European Central Bank and central banks of Sweden, Denmark and Switzerland in imposing negative rates on excess commercial bank reserves. The BoJ's announcement is in direct response to disappointing economic performance, worries about low inflation and weak bank lending. The negative 10 basis point interest rate will augment the BoJ's ongoing massive quantitative-qualitative easing (QQE). Under QQE, the BoJ is the dominant purchaser of Japanese Government Bonds (JGBs) as well as other financial assets.

The coming year will likely be driven a potentially weaker currency, progress on structural reform, but hopefully better corporate governance coming through in higher dividends and share buybacks. There is also an election coming up in the summer, so the government will be incentivised to keep the market as positive as best they can, at least through the summer.

For those investors able to take a longer term view, we still believe there is a positive investment story. Our central scenario is that Abe's political will to make, in his own words, "Japan a great and robust country," is real. Policy efforts should provide further traction in the next 12-24 months – we will continue to look for further signs, beyond this time horizon, that Japan is turning into a durable improvement and self-help story.

EMERGING MARKETS: Emerging markets have continued to suffer on concerns over economic slowdown. We feel like we have been here before, however, and we believe a growth slowdown should not be confused with a growth "crisis". China still has the resources to manage through this transition. Meanwhile, the outlook for other parts of the EM world remains positive. In South East Asia, for example, countries such as the Philippines, Indonesia and Thailand remain vibrant areas. Their governments have recently announced plans to spend billions of dollars on new infrastructure over the next few years to spur growth, as the traditional export-driven model loses steam.

We are also focused on countries that are implementing meaningful reforms that are aimed at improving the quality and sustainability of their growth. India, Mexico, Indonesia, and even China have begun to implement important and much needed reform programs. However, the varying pace and success of those efforts in each country will continue to drive greater divergence in relative performance.

Key to our broad outlook is that dispersion within EMs. Our approach has always been to look at economies and stocks in a very granular way. Despite the overall slowdown, we would encourage investors to see through the negative headlines about economic growth and instead focus on the prospects of individual companies. Valuations are compelling and remain at a discount relative to their history and to their developed-market peers.

Overall, we sense many risks are already priced into EMs, and certainly many of these countries we visit now feel good value. Valuations are certainly attractive, both relative to history, and versus developed market counterparts. Indeed, the emerging versus developed market equity performance has been quite extreme. Often, it pays to be contrarian, with the best time to invest being when sentiment is at a low. If you are able to take a long-term view, and look through short-term market volatility, we believe there are rewards to be found within this more dispersed EM world.

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